



State Of California
Business, Transportation And Housing Agency
DEPARTMENT OF CORPORATIONS
California's Investment and Financing Authority

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"FAIRNESS" HEARINGS AND SHELL COMPANIES

Corporations Code Section 25142 authorizes the Commissioner of Corporations (the "Commissioner") to hold "fairness" hearings on the issuance of securities or delivery of other consideration in exchange for one or more bona fide outstanding securities, claims, or property interests, or partly in such exchange and partly for cash. The "fairness" hearing process may be used for the exemption available to issuers under Section 3(a)(10) of the Securities Act of 1933 ("Securities Act"). Corporations Code Section 25142, however, does not mandate the holding of a hearing to determine the fairness of a securities transaction, but merely authorizes the Commissioner, upon request, to hold a hearing and to approve the fairness of the terms and conditions of the issuance of securities. See Commissioner's Release No. 102-C (revised Dec. 1, 1998); see also Securities and Exchange Commission, Division of Corporation Finance, Staff Legal Bulletin No. 3 (revised Oct. 20, 1999). Hence, "fairness" hearings are voluntary in nature and held at the discretion of the Commissioner.

The purpose of this release is to set forth certain observations of the Commissioner with respect to applications for a permit under Corporations Code Section 25121 involving shell companies where a "fairness" hearing is requested.

Rule 260.140.137 at Title 10 of the California Code of Regulations ("CCR") addresses shell companies, but only in the context of nonissuer transactions. Rule 405 under the Securities Act and Rule 12b-2 under the Securities Exchange Act of 1934 (the "Exchange Act") define a "shell company" as a registrant, other than an asset-backed issuer, with (i) no or nominal operations and (ii) either (a) no or nominal assets, (b) assets consisting solely of cash and cash equivalents, or (c) assets consisting of any amount of cash and cash equivalents and nominal other assets.

The Commissioner may look to the federal securities laws and the interpretations of the Securities and Exchange Commission ("SEC") and its staff for interpretive and other authoritative assistance when administering the Corporate Securities Law of 1968 in the absence of California law on the subject. See Commissioner's Release No. 110-C.

Under recently adopted SEC regulations generally effective in August 2005, once a shell company (other than under certain limited conditions) ceases to be a shell company, it must file a current report on Form 8-K containing the same type of information that would be required by filing a general form for registration of securities on Form 10 or Form 10-SB, as applicable, under the Exchange Act. See generally Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, Securities Act Release No. 33-8587 (July 15, 2005).

In determining whether a proposed issuance of securities is fair, just, and equitable under Corporations Code Section 25140, the Commissioner is guided by CCR Rule 260.140 and following. CCR Rule 260.140.61 indicates that mergers should provide for the issuance of securities that fairly reflect the relative values of the corporations that are party to the plan of reorganization.

The Commissioner observes that under the "reverse merger" and "back door registration" transactions proffered by shell companies and described in Securities Act Release No. 33-8587, a private operating company can become a publicly reporting company. In return, the promoters of shell companies generally receive ownership interests in the resulting entity, which dilutes the ownership interests of the existing securityholders of the private operating company. The Commissioner notes that under the recently adopted SEC regulations, a private operating company could, as an alternative, simply become a publicly reporting company by registering its securities under the Exchange Act and filing a Form 10 or Form 10-SB with the SEC, without any dilution to its existing securityholders and without the assumption of any unknown or contingent liabilities from a shell company.

In the absence of other countervailing benefits to the private operating company, the Commissioner has difficulty in finding proposed issuances as a result of "reverse merger" and "back door registration" transactions by shell companies fair under Corporations Code Section 25140 and CCR Rule 260.140.61 and will normally exercise discretion by declining to hold "fairness" hearings with respect to these applications.

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